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Timothy Geithner's secrecy problem

Rep. Brad Miller

Matthew Yglesias got the dispute between Neil Barofsky and Tim Geithner [partly right.]

Barofsky, the former special inspector general of the Troubled Asset Recovery Program, is scathingly critical of Geithner, President Obama's Treasury secretary, in Barofsky's new book, ["Bailout: An Inside Account of How Washington Abandoned Main Street While Rescuing Wall Street."]
Yes, there is "obvious mutual loathing" between the two, and yes, there is a real policy disagreement between them and their allies "about the relative importance of household balance sheets versus the credit channel to laying the preconditions for growth."

"Team Tim would say that they're trying to create a well-capitalized banking system in order to bolster the broader economy," Yglesias blogged at Slate. "Team Neil counters that the broader economy would be better served by a policy that imposed steep losses on banks and instead repaired household balance sheets."

But Yglesias is wrong that "this disagreement was [not] nearly as consequential as either side seems to think." It was not a "relatively narrow disagreement about public policy." It was the defining economic policy decision of the Obama presidency. And it is not a decision that has been openly debated.

We are five years into the housing crisis, and we have yet to break the cycle of foreclosures and declining home values. Foreclosures caused a decline in home values and the decline in home values caused more foreclosures. Vacant foreclosed homes stigmatized neighborhoods, pushing down home values and priced-to-sell foreclosed homes flooded the market.

The data are inexcusably imprecise , but there have probably been 3.5 million completed foreclosures since September 2008. More than 2 million mortgages are in foreclosure, and 3.8 million mortgages are delinquent, almost half of those are three months past due. In all, about 11.7 percent of mortgages are delinquent or in foreclosure. Home values have dropped by 30 percent, a $7 trillion loss in wealth for American families. Approximately one in four borrowers is "underwater," or owes more on his or her home than it is worth.

Almost all middle-class families have had their life's savings evaporate with the decline in equity in their home, and families with little or no life's savings are not eager consumers. Corporations flush with cash still do not expand operations and hire workers because there is little demand for increased goods and services, resulting in continued high unemployment, more foreclosures, and further decline in home values.

The housing crisis has also deprived the economy of an important accelerant in past recoveries: residential construction.

Building permits for new residential units are a leading economic indicator. The demand for residential construction is from new household formation, replacement of obsolete housing and second homes. In past recessions, residential construction declined as the economy slowed and increased as the economy recovered to meet the normal demand as well as the pent-up demand from the recession.

That has not happened in this recession. Housing starts bounced between 1.4 and 1.6 million from 1994 to 2001, and home values increased at approximately the rate of inflation. In 2005, the height of the housing bubble, new home starts were slightly more than 2 million, about half a million more than normal demand. New housing starts returned to pre-bubble levels in 2007, but continued to decline precipitously, falling to 905,500 in 2008 and then hovering at around

600,000 from 2009 to 2011, far more decline than was needed to absorb the oversupply from the bubble years. And the nation lost 1.3 million residential construction jobs from 2007 to 2010.

After doing without during a recession, construction workers flush with overtime wages are eager consumers. Construction workers who have been unemployed or worked part-time for five years are not.

Housing may now have hit bottom, but any recovery will be painfully slow. There are still untold millions of homes in the " shadow inventory ," homes not yet on the market but already owned by banks or hopelessly delinquent and destined for foreclosure.

Team Geithner acknowledges the economic burden of the housing crisis, but argues that they really have tried everything. In fact, Team Geithner opposed every policy proposal that would have relieved homeowners of some mortgage debt to avoid foreclosure, beginning with amending the bankruptcy law to allow judicial modification of home mortgages, or "cramdown."

Yglesias is correct that Team Geithner opposed those policies because the policies were in irreconcilable conflict with Team Geithner's effort to restore "a well-capitalized banking system in order to boost the broader economy." The policies would not really have imposed losses on the biggest banks, but would have revealed losses. Many underwater homeowners could not pay their mortgages and avoid foreclosure, but pretending otherwise allowed the biggest banks to delay recognizing their losses. Immediate recognition of losses on mortgage-based assets would have revealed many of the biggest banks to be very thinly capitalized, maybe even insolvent.

Some economists argued at the time that systemic banking crises occurred regularly in both developing and industrialized nations, and the lesson of those crises was that economic pain was inevitable, but it was far better to take the medicine of quickly recognizing losses and restructuring insolvent banks. Allowing banks to pretend to be solvent by wildly optimistic accounting does not protect "the credit channel." Banks that are allowed to pretend to be solvent are "zombies." Zombie banks hoard capital and do not make the normal, profitable loans necessary for economic recovery. And zombie banks are vulnerable to "looting" by the incumbent management who kept their jobs despite the bank's insolvency. By denying capital for productive economic uses and by blocking needed reforms, zombie banks can cause a protracted period of stagnation, or a "lost decade."

But there were also successful precedents for Team Geithner's approach. The biggest banks were probably technically insolvent in the early '80s as a result of the Latin American sovereign debt crisis. The Federal Reserve lowered interest rates to the biggest banks so their lending would be more profitable, effectively subsidizing the banks. Meanwhile, the banks publicly negotiated with the Latin American nations, knowing full well that the banks would be insolvent if they agreed to what the Latin American nations could pay. Once profits from subsidized lending returned the banks to solvency, the banks agreed to take a "haircut" on the Latin American sovereign debt and finally recognized the losses that were always inevitable. The episode did not result in serious economic or political disruption in the United States.

So maybe Yglesias is right that the policy difference between Team Geithner and Team Barofsky is "not a no-brainer." Team Geithner's response to the banking crisis necessarily made an effective response to the housing crisis impossible, however. It is hard to understand how the economy could get well with the housing sector that sick.

Perhaps more important, the policy debate that Yglesias described has never occurred. Team Geithner's policies may be defensible, but they have not been defended publicly. Team Geithner may acknowledge to some trusted reporters "on background" the reasoning behind their policy decisions, but Team Geithner never publicly acknowledges the fundamental policy choice of allowing banks to delay recognizing losses over helping underwater families avoid foreclosure.

Perhaps Team Geithner feared demagoguery and public rage would make rational policy difficult, but there are consequences of unexplained indulgences for the banks.

One of Team Barofsky's principal criticisms of Team Geithner is a lack of transparency. Transparency provides confidence that institutions deemed solvent really are so that the institutions can attract new capital if needed and can function normally. Transparency allows prompt, realistic treatment of distressed assets, like reducing principal on mortgages to avoid foreclosure. And transparency assures the public that the extraordinary efforts necessary to manage a banking crisis are to help the broader economy, not just a few connected bankers.

Most Americans now believe that the bank bailout was entirely to help bankers, not to help the broader economy. It offends Americans' sense of justice that the people who have suffered the most, the workers who lost their jobs and the families who lost their homes, were relatively innocent, while the bankers who were blameworthy have suffered hardly at all.

Team Geithner argues that whatever the political price, their policies worked and avoided a second Great Depression, which would otherwise have resulted from a systemic banking collapse. "We saved the economy," Secretary Geithner told the New Yorker more than two years ago, "but we kind of lost the public."

Maybe he is right.

Still, it is kind of a problem when we kind of lose the public, since we are kind of a democracy.